**Internal Revenue Service**

# memorandum

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Br.4:KDAllison

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to: Bob Reinhard, International Examiner, E:EB:1106
International Examination Division, Detroit, MI.

from: David F. Bergkuist, Senior Attorney, CC:INTL:Br.4

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subject: [redacted] (INTL-0225-91)

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This memorandum is in response to your request for informal technical assistance dated July 6, 1990, regarding the application of sections 162 and 165 of the Code to the facts set out below with respect to [redacted]'s [redacted] taxable year.

Facts In [redacted], [redacted] incorporated a wholly-owned [redacted] subsidiary, [redacted], to manufacture [redacted] and [redacted]. [redacted] transferred $[redacted] to [redacted] in exchange for all of the stock of [redacted] with which [redacted] purchased assets necessary for its manufacturing business. [redacted] also guaranteed $[redacted] in loans to [redacted]. The incorporation of [redacted] and the decision to expand assembly of [redacted] was part of a strategy to occupy a volume gap left by the inability of [redacted] and [redacted] to produce [redacted]. [redacted] felt it was necessary to incorporate [redacted] in [redacted] rather than in the United States because of the local content requirement for the finished product, as well as to provide a bargaining chip in negotiations with the [redacted] government over the desired assembly site. In [redacted], at approximately the same time that [redacted] was incorporated, the assembly operation was incorporated in [redacted] by [redacted] as [redacted], an operation which was, and continues to be, profitable. [redacted] was [redacted]'s [redacted] source for [redacted], [redacted] and [redacted] components. [redacted] also sold components to [redacted].

For various reasons, [redacted], [redacted] suffered losses from its start-up in [redacted] through [redacted]. In [redacted], [redacted]'s capital was found to be impaired under

[redacted] law and, as a result, [redacted] was required to either contribute more capital to [redacted] or liquidate [redacted] Because the [redacted] board of directors reported that [redacted] would continue to lose money, and because an independent analysis of the stock of [redacted] determined that the stock was worthless, [redacted] sold its assets, worth $[redacted], to [redacted] and [redacted], two domestic first tier subsidiaries of [redacted] that controlled the day-to-day operations of [redacted] in exchange for the assumption by [redacted] and [redacted] of [redacted] debt of an equal amount. [redacted] was liquidated in [redacted]. Another $[redacted] of [redacted] debt not guaranteed by [redacted] remained unsatisfied. The assets acquired by [redacted] and [redacted] continued to be used in their [redacted] branches to manufacture components. [redacted] and [redacted] continue to sell those components to [redacted]s former customers.

For its [redacted] taxable year, [redacted] claimed the $[redacted] of debt that it guaranteed for [redacted] as a bad debt loss under section 166. It claimed the $[redacted] capital contribution as a worthless stock deduction under section 165(g)(3). [redacted]s remaining $[redacted] of unguaranteed debt was claimed by [redacted] as a section 162 expense that it was forced to pay in order to protect its [redacted] goodwill. It is our understanding that you do not challenge the section 166 bad debt deduction of debt guaranteed by [redacted]. Therefore, our consideration will focus on only the section 162 and section 165(g)(3) issues.

Discussion

I. Worthless stock deduction. Generally, worthless securities (including shares of stock as well as debt claims) give rise to a capital loss as of the last day of the taxable year in which they become worthless by virtue of section 165(g)(1). However, worthless securities of a first tier "affiliated corporation" give rise to an ordinary loss deduction under section 165(g)(3). The purpose of this exception to section 165(g)(1) is to roughly approximate the treatment that would have been accorded to the operational loss if the subsidiary operations had been conducted directly by the taxpayer through a branch.

In most of the many cases where stock has been held to be worthless, three factors have been present. First, the stock lacked current or liquidating value, evidenced by insolvency. Morton v. Comm., 38 B.T.A. 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940); Austin Co. v. Comm., 71 T.C. 955 (1979) acq. 1979-2 C.B. 1. Thus, if the fair market value of a company's assets is exceeded by its liabilities, this test is satisfied. It appears that this test is satisfied by [redacted] as the value of its assets, $[redacted] is exceeded by its debt, $[redacted] unless all or part of the debt is recharacterized as equity. However, it is inconsistent with the concept of insolvency

that [redacted], which assembles parts sold to it by [redacted] and sells the finished product, is apparently highly profitable, with (net?) assets of $[redacted] and shareholder capital of $[redacted]. It may be appropriate to raise with the taxpayer the issue of whether, under section 482, some of [redacted]'s gross income from the sale of the [redacted] should be allocated to [redacted] to increase the mark-up on [redacted]'s sale of [redacted] and [redacted] to [redacted] and, thus, reduce [redacted]'s losses. If [redacted] is found to have had heavy operating losses, but was not insolvent, it will be deemed to have had current or liquidating value. John W. Burdan, 37 B.T.A. 642 (1939), aff'd 106 F.2d 207 (3rd Cir. 1939).

Second, the stock lacks potential or future value. Morton, supra; Olds & Whipple v. Comm., 75 F.2d 272 (2d Cir. 1935), 35-1 U.S.T.C. para. 9118. Continuation of a corporation's business normally indicates that management anticipates profits from the business. This could negate the conclusion that the subsidiary had no potential value. However, in Rev. Rul. 70-489, 1970-2 C.B. 53, a parent corporation liquidated its insolvent subsidiary and continued to operate the former subsidiary's business. The ruling permitted the parent to claim a worthless stock deduction without discussing the potential value issue. In the underlying General Counsel Memorandum, [redacted] (GCM 33204 - I-1852), the Service stated that:

> All the parent has done is arrange its affairs in order to recognize the economic losses already suffered on its stock and loan investment in the subsidiary in a manner which we believe is sanctioned by the Code.

This G.C.M. noted that the Service's outstanding position prior to the publication of Rev. Rul. 70-489 allowed both a bad debt and a worthless stock deduction but only where the subsidiary's business was not continued by the parent. Rev. Rul. 59-296, 1959-2 C.B. 87 (G.C.M. 31026 (In re: [redacted]) (extending H.G. Hill Stores, Inc., 44 B.T.A. 1182 (1941), acq. 1942-2 C.B. 9 to mergers). However, in further support of allowing the taxpayer a worthless stock deduction, even when the business is continued by the parent, the G.C.M. noted that a case with facts similar to Rev. Rul. 70-489, supra, had been adjudicated in favor of the taxpayer in A.H. Rude & Co., Ltd., Memo Op. Docket 103676 ((June 30, 1941), acq., A.O.D. September 8, 1941).

G.C.M. 33204 does not address the potential value issue. Varied as the factors considered by the courts are in determining worthlessness, it is believed that the presence or absence of potential value has been consistently used as a threshold test. See Figgie International, Inc., 807 F.2d 59

(6th Cir. 1986), 86-2 U.S.T.C. para. 9813; Olds & Whipple v. Comm., supra; Olson v. Comm., 10 T.C. 458 (1948), acq., 1948-2 C.B. 3.

It is our view that the holdings in G.C.M. 33204 and Rev. Rul. 70-489 are consistent with a requirement that there be no potential value in a business before it is declared worthless. Worthlessness is determined on a case-by-case factual basis. It is, therefore, conceivable that a parent corporation could operate its liquidated, insolvent subsidiary's business without any belief or indication that the business would one day become profitable. Rev. Rul. 70-489 assumed the worthlessness of the subsidiary's stock without any discussion of the supporting facts. In our case, [redacted] must supply facts indicating why [redacted]'s business continued to be operated within [redacted]'s consolidated group, even though that business was currently unprofitable.

Even if [redacted] and its business are held to have no current value or future profit potential, the worthless stock deduction may, nonetheless, remain unavailable if the subsidiary serves another valuable function for [redacted]. In El Paso Co. v. U.S., 694 F.2d 703 (Fed. Cir. 1982), 82-2 U.S. T.C. para. 9711, El Paso Natural Gas Co. (EPNG) incorporated a wholly owned subsidiary, Northwest Pipeline Co. (Northwest), to implement a court ordered divestiture of another corporation held by EPNG. Because of the appellate court's unfavorable ruling on the lower court's divestiture plan and the institution of another plan, in 1967, EPNG deactivated Northwest, leaving it a mere corporate shell. Upon the court's decision to implement a third plan, in 1974, EPNG reactivated Northwest to carry out the plan. In denying a worthless stock deduction to EPNG for Northwest in EPNG's 1967 taxable year, the Federal Circuit stated:

> [Northwest's] utility and value to EPNG did not depend on its profit-making ability. It was formed only to facilitate the mechanics of divestiture . . . . Northwest's capacity to fill that role was never impaired by the Supreme Court edict or otherwise. When [the quantity and mix of properties . . . that Northwest was to receive] were appropriately adjusted in the third divestiture decree, the Court conferred its approval and Northwest discharged the function for which it was created.

El Paso Co., supra at 713-714.

Likewise, [redacted] was created to supply parts to a profitable venture and to fulfill [redacted]'s agreement with [redacted] by providing [redacted] employment. [redacted] carried out its task and was only

liquidated to comply with [redacted] law. It is a measure of the importance of [redacted]'s function in the [redacted] corporate family, wholly apart from profit, that the same function continued to be carried on, in branch form, by [redacted] and [redacted] with [redacted]'s assets.

The third factor that must be present if stock is to be judged to be worthless is an identifiable event. Section 1.165-1(d)(1) of the regulations states:

> A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such a taxable year.

See, U.S. v. S.S. White Dental Mfg. Co., 274 U.S. 398 (1927). Identifiable events include a foreclosure sale of the subsidiary's assets (Eaton v. Comm., 143 F.2d 876 (5th Cir. 1944); Rev. Rul. 72-470, 1972-2 C.B. 100), winding up corporate operations following a binding commitment (Austin Co. v. Comm., supra), expropriation (Rev. Rul. 62-197, 1962-2 C.B. 66), creditors receipt of deficiency judgment after insolvency (875 Park Ave. Co. v. Comm., 217 F.2d 699 (2d Cir. 1954), bankruptcy, appointment of a receiver and liquidation (Morton, supra at n. 8). Other combinations of events have been found to be sufficiently identifiable events. The Ainsley Corp., 332 F.2d 555 (9th Cir. 1964) (disposition of the corporation's inventory, the laying off of employees and the failure to renew a contract for vital raw materials were sufficiently identifiable events to justify a loss deduction).

Even where there was an actual liquidation, the burden of proof is on the taxpayer to show that the stock was valuable in the taxable year prior to the liquidation. Friend v. Comm., 119 F.2d 959 (7th Cir. 1941). In the instant case, [redacted] sold its assets and liquidated in [redacted], the year of the deduction. However, [redacted] operated at a loss from its incorporation in [redacted] through its liquidation. [redacted] apparently always carried major debt which it was never able to service. It may, therefore, be difficult for [redacted] to prove that [redacted] had current or liquidating value at the end of [redacted]. The independent appraiser's report should be carefully examined.

II. Section 162 Expenses.

Section 162 provides for the deduction of ordinary and necessary expenses paid or incurred in carrying on a trade or business. In general, the existence of separate corporate entities must be strictly observed for federal income tax

purposes. The debts and expenses of one company are not those of another. Voluntary payments of those debts and expenses are not deductible as ordinary and necessary expenses. Friedman v. Delaney, 171 F.2d 269, 271 (1st Cir. 1948), cert. denied, 336 U.S. 936 (1949). However, if the primary motive of the payer of another company's debts is to preserve its own good will and credit rating with respect to its operating business, rather than to help the debtor company continue in business (thereby protecting its investment in the debtor subsidiary's stock, a capital investment), the payments are currently deductible. Lutz v. Comm., 282 F.2d 614, 615 (5th Cir. 1960); L. Heller & Son v. Comm., 12 T.C. 1109 (1949), acq. 1949-2 C.B. 2; Dietrick v. Comm., 881 F.2d 336 (6th Cir. 1989). This rule is particularly applicable when the creditors are important customers of the payer. Rev. Rul. 73-226, 1973-1 C.B. 62. It is equally clear that payments made to acquire goodwill must be capitalized. Welch v. Helvering, 290 U.S. 111 (1933). In addition, payments made to protect the goodwill of another corporation's business, even that of a subsidiary, may not be expensed, as such payments protect a capital investment in the stock of the subsidiary. Nalco Chemical Company & Subsidiaries v. U.S., 561 F.Supp. 1274 (1983 U.S.D.C. No. Dist. Ill. E. Div.).

The burden of proof is on the taxpayer to supply evidence that the goodwill of the taxpayer's own customers or creditors was endangered. Self-serving testimony by the taxpayer as to information and belief that goodwill would be harmed by a failure to make a voluntary payment is insufficient. Nalco, supra. In Heller, supra, the taxpayer manufactured and dealt in jewelry. Its subsidiary sold jewelry as well as cosmetics and perfume. The taxpayer's credit rating with the Jewelry Board of Trade suffered when 55% of the subsidiary's bills remained unpaid after a bankruptcy court decision. The Jewelry Board of Trade told the taxpayer its rating would improve if it paid the remaining 45% of the subsidiary's debts. The taxpayer did pay the debts and its credit rating returned to excellent. The Tax Court held the payments were deductible as they were made to protect the taxpayer's credit rating. Likewise, in Scruggs-Vandervoort-Barney, Inc., 7 T.C. 779 (1946), acq. 1946-2 C.B. 5, the taxpayer, a retailer, was told by local bankers that it should pay off the creditors of the taxpayer's newly acquired subsidiary bank, to avoid loss of these creditors as potential customers of the taxpayer. The Tax Court ruled that the payments should be currently expensed.

However, in Nalco, supra, the taxpayer could not substantiate its fear of a loss of goodwill. Its only evidence consisted of the testimony of its officers regarding their educated guesses about the effect of the nonpayment of the debts of its financing subsidiary to an unrelated third party

bank would have on the taxpayer's credit. Furthermore, in addition to focusing on the taxpayer's failure to provide objective proof of a loss of goodwill, the court gave great weight to the fact that the taxpayer's original motive for entering into the transaction that ultimately resulted in the voluntary payment was to shore up its subsidiary's capital structure.

The facts in Nalco indicate that the taxpayer manufactured and sold chemicals. S1 sold the taxpayer's chemicals in the United Kingdom. S1 merged with an unrelated United Kingdom water treatment service corporation, S2, and the taxpayer received 50% ownership of S2. The taxpayer made a loan to S2 that had to be repaid prematurely in order to comply with FDIC regulations restricting the flow of outbound capital investment. In order to effectuate repayment of the loan without stripping S2's capital structure, the taxpayer organized a Swiss finance corporation (S3) to borrow money from a Swiss bank, which S3 then lent to S2. S2 repaid the taxpayer's loan with the proceeds. However, the taxpayer was forced to guarantee the loan by the Swiss bank to S3 and indemnify S3 against foreign currency losses with respect to the loan to S2. The FDIC later repealed the regulations restricting offshore capitalization and the taxpayer made a direct loan to S2. S2 repaid S3 and S3 repaid the Swiss bank. S3, suffered foreign currency losses and could not repay the Swiss bank. The taxpayer repaid the bank on behalf of S3 under the indemnification agreement and deducted the repayment under section 162.

The District Court held that the taxpayer's indemnification of S3's losses was voluntary as S3 could have protected itself with a hedging transaction. The court further determined that, because the FDIC regulations regarding capital investment forced the making of the original loan, necessitating the later payment by the taxpayer, the voluntary payment by the taxpayer was a capital transaction:

> . . . Nalco has not shown that its payments bore the necessary relationship to its own business. The need to incur the obligations under scrutiny grew out of Nalco's status as a shareholder. Furthermore, the efforts made by the taxpayer to correct its investment difficulties did not proximately influence the course of its business.

Nalco, supra at 1289.

Because [redacted] was liquidated prior to [redacted]'s assumption of its debts, it would seem that the assumption was not entered into to protect [redacted]'s capital investment in [redacted]. However, [redacted] may have assumed the debt in order to protect its capital

investment in the stock of [redacted] and [redacted] with respect to their [redacted] operations, rather than to protect its own operations. Alternatively, in favor of allowing [redacted]'s deduction, all parts made by [redacted] and [redacted], and assembled by [redacted] for [redacted] '[redacted]' [redacted] sales are known to be [redacted] '[redacted]' [redacted]. Therefore, any direct sales by [redacted] into the [redacted] market, to the same customers and utilizing the same creditors and governmental cooperation as [redacted]'s business (now [redacted] and [redacted]'s business) may have been adversely affected by [redacted]'s failure to assume. [redacted] must provide empirical evidence of a loss of reputation.

Nonpayment of [redacted]'s debts would seem to most directly affect the goodwill of [redacted] and [redacted] as successors to [redacted]'s business. The more direct and proximate the harm of nonpayment is to the operation of the businesses of [redacted], [redacted] or [redacted], the more closely are [redacted]'s payments tied to protecting their goodwill and, therefore, [redacted]'s capital investment in their stock. [redacted] must come forward with objective proof of the effect of nonpayment on its own business.

III. Questions In order to properly respond to the specific issues raised in your request for informal technical assistance, additional information is needed. In particular, [redacted] must provide additional facts before a determination of whether [redacted]'s voluntary payment of the nonguaranteed debt of [redacted] was made to protect its own goodwill and reputation or whether [redacted]'s payment was for purposes of guarding [redacted]'s capital investment in one or more of its subsidiaries. To better evaluate the above described transaction, it is suggested that the taxpayer provide responses to the following questions and requests for additional information:

(a) Identify [redacted]'s creditors and offer proof that they were, or are, creditors or potential customers of [redacted].

(b) Produce evidence (other than statements of belief by [redacted] personnel) that [redacted] would have lost customers, credit rating, stock value or the support of the [redacted] government if the voluntary payments of [redacted]'s debt had not been made.

(c) Provide an explanation of why a bank creditor would expect [redacted] to pay [redacted]'s debts not guaranteed by [redacted] thus affecting [redacted]'s credit or goodwill with the creditor. [Perhaps if the banks (or other creditors or suppliers) are in [redacted] the [redacted] government could have stated that if the [redacted] creditors were not paid, [redacted] would receive no more [redacted] governmental support].

(d) Explain why [redacted] was operating at a loss, based partially on "lower than anticipated market penetration and demand for its products", when its main customer, [redacted], was operating

profitably in the same market with a finished product assembled in part from products made by [redacted]. [Is it possible to review the transfer pricing arrangements between [redacted] and [redacted]?]

(e) Did [redacted] assume [redacted]'s debt and pay off [redacted]s creditors at less than face value? If so, [redacted] may have cancellation of indebtedness income. If [redacted] did not assume the debt but paid off the debt at less than face value, [redacted] may have cancellation of indebtedness income.

(f) Offer adequate proof that [redacted] was not insolvent at the end of its [redacted] taxable year.

(g) Explain why [redacted] continued to operate [redacted]s business as branches of [redacted] and [redacted], even though the business had always been unprofitable.

(h) We believe that it is likely that [redacted]s losses from the worthless stock and from the voluntary payment of [redacted]s debts, if allowed, are related to a class of [redacted]s foreign source gross income under section 1.861-8, and should, therefore, be classified as foreign source losses and used to reduce [redacted]s foreign source income. If [redacted] has reduced U.S. source income with these losses, the issue should be examined. We would, of course, supply an analysis of the issue if needed.

IV. Conclusions

(1) Worthless stock deduction

Although [redacted] was probably insolvent at the end of [redacted], the taxpayer must offer further proof that [redacted]s business was continued in [redacted] and [redacted] for reasons other than [redacted]'s belief in the future profitability of the business. Furthermore, [redacted] must distinguish its situation from that in El Paso Co., supra. [redacted] must also prove that [redacted] had no liquidating value at the end of [redacted] and, therefore, that the proper year for the 165(g)(3) deduction is [redacted].

(2) Section 162 Expenses

[redacted] must prove, through external sources, that its goodwill with respect to its operations was endangered, and that its expenditures were made to protect its own goodwill rather than to protect its capital investment in [redacted], [redacted] or [redacted].

We hope that this information will prove helpful to you. If you have any further questions, please contact Ken Allison on FTS 566-6442.